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RESIDENTIAL UTILITY CONSUMER OFFICE

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Janet Napolitano  
Governor

Stephen Ahearn  
Director

August 19, 2005

Commissioner Kristin K. Mayes  
Arizona Corporation Commission  
1200 West Washington Street  
Phoenix, Arizona 85007-2996

AZ CORP COMMISSION  
DOCUMENT CONTROL

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Re: APS Application for Surcharge; Operation of Surcharge and  
Purchase Supply Adjustor: \$100 Million Surcharge Cap  
Docket No. E-01345A-05-0526

Dear Commissioner Mayes:

The Residential Utility Consumer Office ("RUCO") appreciates this opportunity to respond to your letter of August 4, 2005 concerning RUCO's expectations regarding Arizona Public Service Company's ("APS") power supply adjustor ("PSA") and the record before the Commission when it adopted the PSA in Decision No. 67744.

From the outset, RUCO viewed the annual PSA adjustment as the primary vehicle through which APS would recover incremental fuel and purchased power costs above/below the base cost established in the settlement. All of the Company's costs for fuel and purchased power would be debited to the balancing account. The balancing account would be credited for all off-system sales revenues, and for the base cost times total kilowatt hour sales. Any difference between those numbers would be subjected to a 90%/10% sharing. To reduce the volatility customers experienced, the PSA was only permitted to adjust once per year. Therefore, any account balance resulting from the above process would be divided by projected kilowatt hour sales to determine the annual PSA adjustment. To further reduce volatility, each year's resulting PSA adjustment would then be subjected to the 4 mil per kWh maximum. Annual changes to the PSA adjustor would become effective on April 1 unless suspended by the Commission. See Hearing Transcript, Vol. I, pgs. 160-161 (Wheeler); Vol. VI, pgs. 1215-18 (Robinson, Diaz Cortez, Keene), Docket No. E-01345A-03-0437; Settlement Agreement ¶¶ 19(b), (d).

In recognition of the fact that actual fuel and purchased power costs could potentially exceed the amount that would be collected by the banded PSA adjustor, the settlement provided for the possibility of a surcharge as a pressure release valve that could be implemented before the next regular annual adjustment if the balancing account grew to an unmanageable level. See Hearing Transcript Vol. I pg. 161 (Wheeler); Vol. II pgs. 383 (Johnson), 388, 391-393, 409-410 (Wheeler); Vol. VI pgs. 1182-84 (Diaz Cortez), 1185 (Robinson), Docket No. E-01345A-03-0437. The Company was obligated to either seek a surcharge, or inform the Commission why it did not believe a surcharge was necessary, any time the PSA account balance reached \$50 million. Settlement Agreement ¶ 19(e). Unlike the annual modification to the PSA adjustor which could become effective without Commission action, a surcharge could only be implemented upon approval of the Commission. *Id.*

As you know, the Commission modified certain aspects of the PSA from those proposed by the parties to the Settlement Agreement. However, those modifications did not change RUCO's view of the PSA, and any approved surcharges, as a device through which APS would recover ninety percent of its prudent costs of fuel and purchased power.<sup>1</sup> The Commission's modifications to the parties' settlement proposal changed certain details regarding whether APS would recover costs through the regular PSA modifications to take place each April, or through a separate Commission-approved surcharge. However, none of the Commission's revisions changed the underlying premise that the costs would be recoverable.

Because the Settlement Agreement requires APS to inform the Commission when its bank balance reached \$50 million, RUCO expected that APS would make such notification prior to the regular PSA adjustment in April 2006. See Transcript of March 28, 2005 Open Meeting in Docket No. E-01345A-03-0437, pgs. 283-84 (Davis). However, neither the language of the Settlement Agreement nor the modifications adopted by the Commission require the Commission to take any particular action in response to such a filing.<sup>2</sup> To the contrary, there was both expressed and implied recognition that a "\$50 million filing" might not result in any action by the Commission.

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<sup>1</sup> The Commission's modification that would impose a \$776.2 million cap on annual net fuel and purchase power costs that could be recovered through the PSA would affect recoverability of amounts above that level, but this provision does not appear to be implicated by APS's recent surcharge filing and so will not be taken into account for purposes of this letter.

<sup>2</sup> This characteristic of the "\$50 million filing" appears to be the very reason the Commission modified the Settlement Agreement to make the 4 mil bandwidth on the regular PSA adjustments an overall bandwidth rather than an annual bandwidth. By limiting the automatic adjustments to those that fall within an absolute 4 mil bandwidth, the Commission effectively limited the Company's opportunity to pass through costs without specific Commission review and action.

The Settlement Agreement expressly provides that the Company may make such a filing, but not request any action by the Commission (Settlement Agreement ¶ 19(e)). Further, statements by the Company and ALJ Farmer at Open Meeting appear to assume that after a 4 mil PSA adjustment is implemented, the balancing account could still have a balance in excess of \$50 million, suggesting that when the Company informed the Commission of a growing balance, no action was taken to reduce that balance prior to the April PSA adjustment. Transcript of March 28, 2005 Open Meeting in Docket No. E-01345A-03-0437 pgs. 259 (Wheeler) and 283 (Farmer). In addition, in discussing what customer bills could reflect in April 2006, the Company recognized that the balancing account reaching \$50 million need not result in a surcharge being implemented before next April. Transcript of March 28, 2005 Open Meeting in Docket No. E-01345A-03-0437 pg. 295 (Wheeler).

RUCO does not believe the Commission is bound to adopt a surcharge as requested by APS at this time. However, the PSA mechanism requires customers to pay their 90% share of incremental fuel and purchased power costs. The alternative to the customers beginning to reduce the undercollected bank balance sooner is not to require the Company to absorb that balance, but to compound interest on it and require customers to pay an increased amount later.

The PSA's provision that incremental costs above a certain level would require specific Commission action before being passed along to customers was never meant to serve as a mechanism to require the Company to shoulder increased responsibility for fuel and purchased power cost increases. At the hearing, AECC witness Higgins confirmed to the ALJ that the PSA and associated surcharges would permit the Company to recover all of its prudent fuel and purchased power costs. Hearing Transcript, Vol. II, pgs. 400-401, Docket No. E-01345A-03-0437. Several Commissioners expressed similar understanding that the modifications the Commission was making in adopting Chairman Hatch-Miller's Amendment #2 (requiring that the Company seek a surcharge prior to its balancing account reaching \$100 million) did not contemplate that amounts ultimately incurred above the \$100 million would be written off, but that the amendment was merely meant to address issues of the timing of any such recovery. Transcript of March 28, 2005 Open Meeting in Docket No. E-01345A-03-0437, pgs 241-42 (Hatch-Miller), 271 (Spitzer), 276, 279 (Mundell). In addition, the language of Decision No. 67744 (language that originated in Hatch-Miller Amendment #2) provides that after seeking a surcharge to recover a bank balance of between \$50 million and \$100 million, the bank balance would be reset to zero unless otherwise ordered by the Commission. Decision No. 67744, pg. 17, lines 15-16. Such a provision would be unnecessary if the Company were only permitted to seek one surcharge and

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was required to forgo all other fuel and purchased power costs not recovered through the base rate plus any existing PSA adjustor.

The Company's application indicates that, even with the surcharge to begin recovering the \$100 million in November, it still expects to seek a 4 mil adjustment to the PSA in April 2006 to recover the expected \$35 million balance as of October 31, 2005 (the balance after the \$100 million to be collected through the surcharge is credited to the balancing account), plus the costs for the remainder of 2005. Rather than implementing both a 4 mil PSA adjustment and a surcharge in or around next April, when higher summer rates are in effect and monthly kWh consumption is rising, the Company proposes to decrease the volatility of customers' bills, permitting customers to take smaller steps by spreading out collection of the \$100 million over 2 years, beginning this November, and implementing the regular PSA adjustment next April.

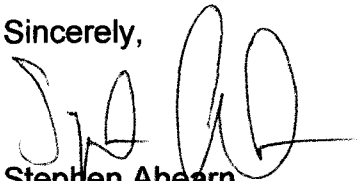
In this response, RUCO is not addressing the prudence of APS's fuel and purchased power costs since April, including costs related to generation and distribution downtime. However, APS agrees that the time for a prudence review is not limited to the period prior to implementation of a surcharge. The Commission could chose to implement a surcharge, undertake a prudence review later, and require APS to make any refunds through the PSA mechanism for any amounts determined to be imprudent.

In conclusion, RUCO believes that the parties to the Settlement described to the Commission their intention that the PSA adjustor and related surcharges would permit the Company to recover 90 percent of its prudent fuel and purchased power costs, that APS was likely to hit the \$50 million trigger some time in 2005, and that the Commission would have an opportunity to determine whether it would be appropriate to relieve the pressure of a growing bank balance immediately or at some later time. Further, the surcharge mechanism was not meant to serve as a device to disallow the recovery of costs, but was intended to permit the Commission to consider the timing and duration of recovery of costs should they exceed those recoverable through the annual PSA adjustments. While the Commission is not obligated to grant APS's pending surcharge application, the alternative to implementing a surcharge in November is not to shield customers permanently from increased costs, but to continue to accrue the obligation (with interest) that customers will eventually be required to repay.

I hope you find this information helpful. If you desire anything further, please do not hesitate to request it.

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Sincerely,

A handwritten signature in black ink, appearing to read 'Stephen Ahearn', written over the word 'Sincerely,'.

Stephen Ahearn  
Director

SA:eg

cc: Docket Control  
Chairman Jeff Hatch-Miller  
Commissioner Mike Gleason  
Commissioner William Mundell  
Commissioner Marc Spitzer  
Lyn Farmer, Hearing Division  
Christopher Kempley, Legal Division  
Thomas L. Mumaw